

MASTER PLAN 2004/CLOSING THE HIGHER EDUCATION FUNDING GAP: NEW REVENUE OPTIONS

December 2002

I. Background: State Tax System

A. Characteristics

Sales and Use Taxes

- Washington relies heavily on the retail sales and use taxes, which provide 46 percent of state and local government revenues.
- The sales and use taxes are expected to generate \$12.9 billion for the state's general fund in the 2003-05 biennium (57 percent of the total).
- The retail sales and use tax rates are:
 - state – 6.5 percent (no change since 1983)
 - local – 0.5 percent to 2.3 percentfor a maximum rate of 8.8 percent in urban areas of King County.
- Only three states are higher than Washington in combined state and local sales tax rates (Oklahoma, Louisiana, and Alabama).
- The sales and use taxes are “inelastic” (in the long-run they grow more slowly than the economy) and are “volatile” (during boom periods they can grow more quickly than the economy; during busts they can grow more slowly than the economy).

Property Tax

- Property taxes provide another 32 percent of state and local government revenues.
- For the state's general fund, the state property tax levy is expected to bring in \$2.5 billion in the 2003-05 biennium (11 percent of the total) with another \$568 million going to the Student Achievement Fund (created in I-728).
- The average effective property tax is 1.16 percent of market value (\$12.52 per \$1,000 of assessed value).
- Washington ranks 17th among the states in property taxes per \$1,000 of personal income.
- Property taxes are of two varieties:
 - Regular levies – non-voter approved, and
 - Excess or special levies – voter approved.

Business and Occupation Tax

- Washington is the only state with a gross receipts (business and occupation) tax.
- In the 2003-05 biennium, the B&O tax is expected to raise \$4.2 billion for the state's general fund (19 percent of the total).
- The major B&O tax rates are:
 - manufacturing and wholesaling – 0.484 percent;
 - retailing – 0.471 percent; and
 - services – 1.5 percent.

Other State Taxes

- Other major state taxes include:
 - Real estate excise tax – \$898 million (4 percent)
 - Public utility tax – \$548 million (2 percent)
 - Insurance premiums tax – \$406 million (2 percent)
 - A combination of liquor and cigarette taxes/profits – \$377 million (2 percent)

Income Taxes

- Washington has no personal incomes tax (as do 43 other states).
- The other six states without a personal income tax are Alaska, Nevada, Wyoming, South Dakota, Texas, and Florida (each of these has a sales tax, as does Washington).
- Washington has no corporate income tax (as do 46 other states).

Tax Fairness

- Washington's tax system is regressive – the total of state and local taxes paid by households with less than \$20,000 in annual income was on average 16.1 percent of their income, while for households with more than \$130,000 in annual income, the average tax was 4.6 percent of their income.
- While income and property taxes are deductible for federal income tax purposes for those households that itemize deductions, sales taxes are not – costing Washington taxpayers \$523 million in additional federal income taxes annually.

Comparison to Other States

- Washington's tax burden of \$111.25 in state and local taxes per \$1,000 of personal income ranks 20th among the 50 states (1999).
- Washington's tax burden ranking has ranged from 39th in 1981 to 9th in 1991.
- Washington ranks fourth among the states in the share of taxes initially paid by business.
- Washington ranks 45th among the states in the share of taxes initially paid by households.

Primary sources: "Washington's Tax System," presentation by the Washington Department of Revenue for the Washington State Structure Committee, October 15, 2001; "November revenue forecast," Office of the Forecast Council, November 15, 2002; and "Draft Equity Findings," Washington State Tax Structure Study, May 10, 2002.

B. History**Early Years**

- In territorial times and for the first 45 years of statehood, Washington derived most tax revenues from property taxes.
- The original state constitution contained no limit on property tax rates, and the tax was used to finance new and expanding governmental programs (by the 1930s, the property tax was about three percent of market value).
- Two "blue ribbon" tax committees during the 1920s both recommended that the tax structure be broadened so property tax burdens could be lowered.

- In 1929, the Legislature imposed an income tax on banks; in 1930 the State Supreme Court found it to be unconstitutional.
- In 1932, the voters passed the first 40-mill property tax levy limit law (in effect, limiting regular property taxes to 2 percent of market value).
- In 1932, the voters also passed an initiative establishing individual and corporate income taxes.
- In 1933, the State Supreme Court found the income taxes to be unconstitutional on the grounds that they were taxes on property and in violation of the constitutional uniformity requirement for property taxes.

1935 Revenue Act

- 1935 Revenue Act – complete change in state government’s tax system.
 - New taxes still in use: retail sales; compensating (use); liquor; cigarette.
 - Prior taxes reimposed: business and occupation; public utility; inheritance (since repealed).
 - New taxes not in use today: admissions (transferred); stock transfers (vetoed); radio (unconstitutional); fuel oil (repealed); conveyance (repealed); medicines and toiletries (vetoed); store licenses (vetoed); gift (repealed); corporation net income (unconstitutional).
 - State Supreme Court rules that the retail sales and B&O taxes are excise taxes – the Legislature is given wide authority as to rates, exemptions, classifications, etc.

Since 1935

- Pre-World War II – Raising rates and broadening bases:
 - 1937 – Motor vehicles transferred to excise tax (MVET).
 - 1939 – Sales tax broadened to include food and services to personal property.
 - 1941 – Sales tax extended to services to real property.
 - 1941 – Sales tax increased from two percent to three percent.
- World War II Period – Expenditure growth limited by war and surpluses accumulate
 - 1944 – 40 mill limit written in state’s constitution
 - Constitutional dedication of gas tax for highway purposes
- Post-World War II
 - 1948 – Expenditures increase – welfare initiative, baby boomers
 - 1951 – General fund deficit, excise taxes increased (including creation of Real Estate Excise Tax)
- 1959 Tax increases
 - Sales tax increased from 3.33 percent to 4.0 percent
 - B&O surtax from 40 percent to 76 percent
 - Liquor tax from 10 percent to 15 percent
 - Cigarette tax from 5 cents to 6 cents
 - MVET from 1.5 percent to 2.0 percent
- Property tax – new limits/reductions
 - 1965 – enacted property tax lid law
 - 1966 – Passed retired person constitutional amendment

- 1969 – Court orders 50 percent assessments
 - 1970 – Legislature cuts millage rate
 - 1970 – Approved current use constitutional amendment (lower values for timber, agriculture and open space)
 - 1971 – Legislature passes the 106 percent levy lid
 - 1971 – Voters approve the one percent property tax limit (regular property taxes cannot exceed one percent of market value)
- Income tax proposal – 1969
 - One percent property tax limit
 - Single rate income tax with referendum for graduated rates in 1975
 - Measure failed by a vote of 2 to 1
- City and county 0.5 percent sales tax first authorized in 1970
- Tax reform proposal – 1973
 - Graduated individual rates not to exceed eight percent
 - Corporate top rate of 12 percent
 - Full funding of schools
 - Special maintenance and operation (M&O) school levies prohibited
 - Exemption of business inventories
 - A rate cap on state and local sales taxes of 5.3 percent
 - Exemption of food from sales tax
 - Eliminate B&O tax
 - Defeated 3 to 1
- 1976 – Court orders full funding of basic education
- 1977 – Sales tax taken off food by initiative
- 1981 – Inheritance and gift taxes eliminated by initiative
- 1981 – Increase sales tax rate 4.5 percent to 5.4 percent
- 1982 – Double round of surcharges; food subject to sales tax for 14 months
- 1983 – Sales tax increase from 5.4 percent to 6.5 percent
- 1993 – Last major tax increase
 - B&O service category experienced large increases
 - Most rate increases have been roll backed since then
- 1993 – I-601 passed to limit growth in state expenditures
- Other recent initiatives and referenda:
 - Ref. 47 – Property tax levy lid reduction (CPI)
 - Ref. 49 – Transfer MVET funds to transportation
 - I-695 – Eliminates the MVET
 - I-728 – K-12 class size reduction; transfers money from general fund to Student Achievement Fund
 - I-732 – COLAs for K-12 teachers
 - I-747 – Limits property tax levy lid to one percent
 - I-753 – Increases the cigarette tax by 60 cents

Primary sources: “Major Milestones and Trends in Washington’s Tax Structure, 1935–2001,” presentation by Don Burrows for the Washington State Tax Structure Committee, November 2001; and “History of Taxes in Washington,” Don Burrows and Don Taylor, 1984.

C. Impact on 2003-05 State Revenues of Recent Ballot Measures

R-47 Property tax reduction	\$906 million
R-49 MVET transfer from general fund to transportation	\$301 million
I-747 Property tax reduction	\$117 million
I-728 K-12 class size (diversion of property tax and lottery)	\$770 million
I-732 Teacher COLA	<u>\$280 million</u>
Total impact on State General Fund	\$2.374 billion
I-695 Eliminated MVET (unconstitutional/Leg. passed)	\$1.871 billion

Source: Office of Financial Management, November 6, 2002.

D. Budget Shortfalls: 2003-05, 1993-95, 1983-85, and 1981-83**2003-05**

Revenue forecast (November 2002)	\$22.7 billion
Maintenance Level Budget "Plus"*	<u>\$24.7 billion</u>
Shortfall	(\$2.0 billion)
Percent of Revenues	9 percent

*Includes costs to carry-forward current policies of the 2001-03 biennium plus other costs such as a higher estimate of health care inflation, salary cost-of-living increases for state employees (not covered by I-732), employee health benefits maintained at current level, and tort costs. Does not include increased higher education enrollments.

1993-95**Total tax increases of \$700 million and total collections of \$16.6 billion; 4 percent**

- Sales tax extended to selected services.
- B&O tax on business services increased from 1.5 percent to 2.5 percent.*
- B&O tax on financial services increased from 1.5 percent to 1.7 percent.*
- B&O tax on other services increased from 1.5 percent to 2.0 percent.*
- Temporary B&O surtax of 6.5 percent applied to other classifications.

*These tax increases were later rolled back to 1.5%.

In constructing the 1993-95 GF-State biennial operating budget, the Legislature faced a basic shortfall of \$1.7 billion between the March 1993 forecasted general fund revenues and the original maintenance level budget. Policy enhancements, including continuation of local criminal justice assistance, and an increase in the size of the general fund reserves increased the overall budget shortfall to \$2.1 billion.

To close the shortfall, the Legislature focused on three primary mechanisms. First, state general fund spending reductions of \$701 million were made. This included \$167 million in reductions

to the original maintenance level Essential Requirements Level (ERL) budget, and \$534 million in policy cutbacks. Second, fund shifts and other revenue adjustments totaling \$753 million were implemented. The most significant of these adjustments was approximately \$368 million in federal fund shifts, primarily in the Title XIX Medicaid program. Third, a general tax package to raise approximately \$649 million in additional revenue was authorized.

Despite the significant budget shortfall, the Legislature provided funding for several new budget initiatives. In K-12 education, \$58 million was provided to support the education reform measure enacted in 1993. The Legislature increased higher education enrollments by more than 10,000 in the budget through \$46 million from the general fund and \$35 million from the new Employment and Training Trust Fund (unemployment compensation). In addition, a total of \$55 million GF-State was added to the State Need Grant program to provide financial aid grants for an additional 18,150 students.

1983-85

Tax increases of \$1.6 billion and total collections of \$8.2 billion; 20 percent

- Sales tax increased from 5.4 percent to 6.5 percent; was not imposed on food.
- Sales tax extended to telephone service (except local residential service).
- B&O tax on services increased from 1 percent to 1.5 percent.
- All surtaxes temporarily implemented in 1981-83 were made permanent.

1981-83

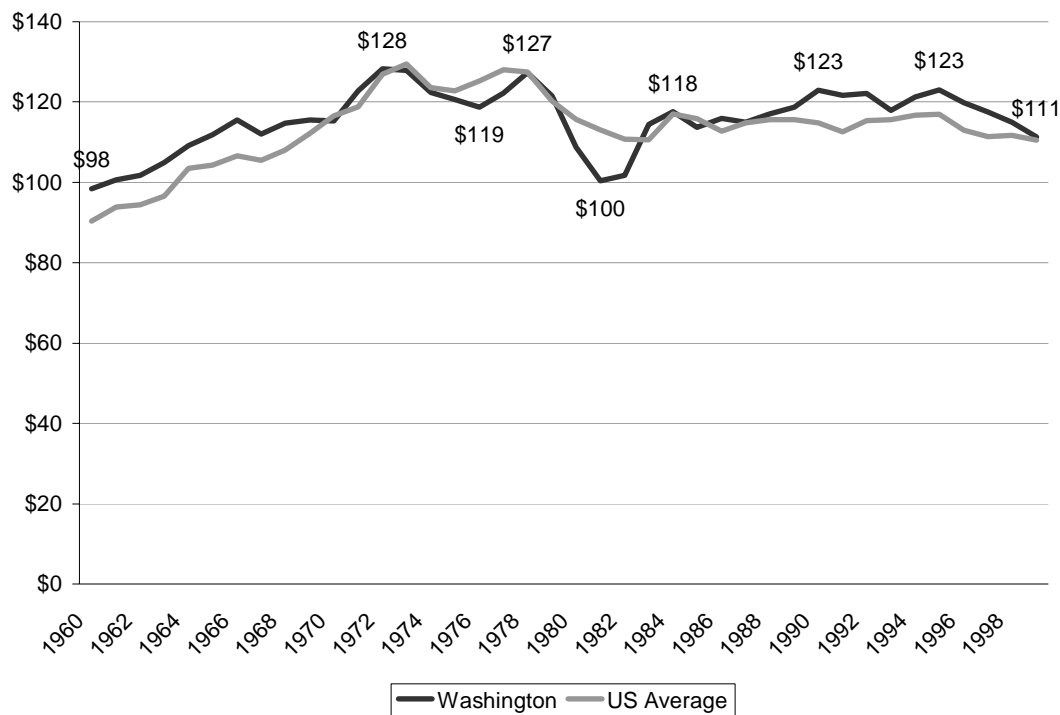
Total tax increases of \$1.5 billion and total collections of \$6.8 billion; 22 percent

- Sales tax increased 4.5 percent to 5.5 percent.
- Cigarette tax increased 16 cents to 20 cents.
- Liquor tax from 4 cents per ounce to \$1.72 per liter.
- Beer tax from \$1 or \$1.50 to \$2.60 per barrel.
- Wine tax from 75 cents per gallon to 20.25 cents per liter.
- Sales tax reduced from 5.5 percent to 5.4 percent and tax reimposed on food products (expires 6/30/83).
- B&O surtax of 4 percent later increased to 7 percent (expires 6/30/83).
- Public utility surtax of 4% later increased to 7 percent (expires 6/30/83).
- Insurance premiums surtax of 4 percent (expires 6/30/83).
- Cigarette tax increased to 20.8 cents and later increased to 23 cents (expires 6/30/83).
- Liquor sales and liter surtax of 4 percent later increased to 14 percent (expires 6/30/83).
- Beer and wine surtaxes of 4 percent later increased to 7 percent (expires 6/30/83).
- Real estate excise surtax of 4 percent later increased to 7 percent (expires 6/30/83).
- Motor vehicle excise surtax of 4 percent later increased to 7 percent (expires 6/30/83).
- State lottery established.

E. State and Local Taxes Over Time and Compared to Other States

- Washington's state and local taxes per \$1,000 of personal income have gone from \$98 of taxes per \$1,000 of personal income in 1960 to a peak of \$128 per \$1,000 of personal income in 1972 and have drifted downward since then.
- In most years, Washington's state and local taxes have been slightly higher than the national average.
- Washington's tax system is volatile and subject to swings based on the state of the economy.
- In 1981, Washington ranked 39th among the states in state and local taxes per \$1,000 of personal income; ninth in 1991; 17th in 1993; 11th in 1995; and 20th in 1999.

**State and Local Taxes Per \$1,000 of Personal Income
Washington and U.S. Average, 1960-1999**

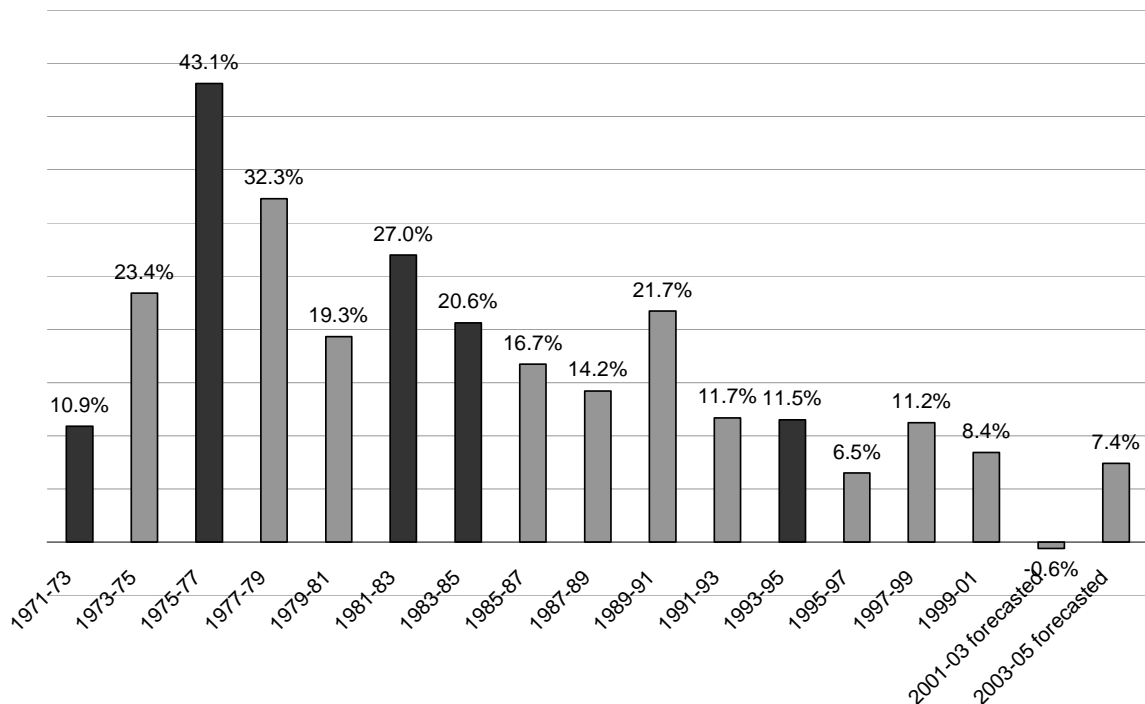


- On a per-capita basis, state and local taxes in Washington were \$3,148 in 1999, ranking 13th among the states. Washington ranked 12th among the states in per capita personal income in 1999.
- The repeal of the Motor Vehicle Excise Tax will first show in the data beginning in 2000.

- Adding \$500 million in new taxes in 2004 would increase the level of taxes by \$2.30 per \$1,000 of personal income. On a per capita basis, this averages to \$81 per person.
- When comparing a state's taxes to other states, it is best to combine both state and local taxes. The states have made different choices as to how to finance governmental programs – primarily public education. For example, Washington funds public education primarily at the state level; thus state taxes in Washington are higher than the national average, and local taxes are lower than the national average.
- There are several ways in which state and local tax burdens may be measured. Each approach has its own merits and is suited to a particular purpose. The two primary methods are the amount of taxes in relation to personal income and population.
- To measure the relative ability of states to finance the cost of government, the total state and local taxes may be divided by the total state personal income – a statistic representing the “wealth” of all residents living in each state. In essence this allows the measurement of state and local taxes as a share of the state's economy. This makes for a good comparison over time and among states.
- Per capita taxes can also be used to measure relative tax burdens. This measure is far from complete because of differences in the level of income among the states that greatly influence their capability to finance the cost of governmental services. Also, over time the level of taxes per capita will increase due to higher incomes and inflation. Year-to-year comparisons need to be adjusted to correct for these influences.

F. State General Fund Collections

- State general fund revenue collections in the 2001-03 biennium are below those of the 1999-01 biennium.
- The four years, 2001-05, represent the slowest growth in state general fund tax collections over three decades.

Biennial (2-Years) Growth in State General Fund Revenues

G. “Gates Committee”

The Legislature passed legislation in 2001 requiring an examination of the current tax system and development of tax alternatives. The legislation created a committee (chaired by Bill Gates Sr.) to determine how well the current tax system functions and how it might be changed to better serve the citizens of the state in the 21st century.

The committee is scheduled to present a report to the legislative fiscal committees on December 3, 2002. The committee met on November 18 and finalized its recommendations and report.

The committee was to examine the elasticity, equity, and adequacy of the state’s tax system. Members were required to develop multiple alternatives that would:

- Increase harmony between tax systems of this state and its border states;
- Encourage commerce and business creation; and
- Encourage home ownership.

The development of the alternatives were to be guided by:

- Administrative simplicity, economic neutrality, fairness, stability, and transparency;
- The alternatives were to range from incremental improvements in the current tax structure to complete replacement of the tax structure;

- Most alternatives were to be revenue neutral and contain no income tax;
- Alternatives were to consider effects of tax incentives and disincentives, including exemptions, deferrals, and credit; and
- The committee was to examine tax structures of other states and review previous tax reform studies.

The committee identified its top 10 problems with Washington's tax system:

- Lower-income households pay a higher percentage of their income in state and local taxes than do higher income households.
- The increasing share of services in consumer spending, along with increased opportunities for making purchases out-of-state, result in taxable retail sales growing more slowly than the economy as a whole over the long run.
- State and local taxes are more burdensome because the retail sales tax paid by households is not deductible from federal income taxes.
- Individuals can avoid sales tax by shopping in bordering states with lower sales tax rates or by making remote purchases.
- It is politically difficult to build and maintain adequate reserve funds during good economic times.
- Initiatives have impacted long run adequacy.
- Some Washington firms are able to avoid the B&O tax by shifting their income generating activities (such as manufacturing) to other states.
- Initiatives and state-imposed reductions in tax bases have impacted local adequacy.
- To the extent that business taxes are passed on to consumers, business taxes are not transparent.
- B&O tax pyramiding (at least 2:1) results in non-neutralities between different industries and between vertically integrated and non-integrated firms.

To address these concerns the committee has a set of recommendations that a majority of committee agrees upon. All of the proposals are "revenue neutral" in that they would not raise more money than the state currently does in a typical year. These recommendations include:

Replacement Alternatives

- A value-added tax to replace the business and occupation tax.
- A flat rate personal income tax to reduce the sales tax and eliminate the state property tax. Share all or part of the state property tax with local governments and/or schools.

Incremental Alternatives

- Extend the retail sales tax to consumer services.
- Extend the current 0.5 percent excise tax on boats to motor homes and travel trailers and consider increasing the rate to 1 percent.
- Review tax exemptions every 10 years to make sure economic and social goals are achieved.
- Avoid dedicated taxes.

- Create a constitutionally mandated rainy day fund.
- Streamline the retail sales tax.
- Simplify local B&O taxes.
- Increase the small B&O tax credit from \$35 to \$70 a month and index the credit to adjust with inflation.
- Exempt construction labor from sales tax.
- Continue to impose an estate tax.

II. Examples of Tax Increases

Annual Collections - 2005
\$ in millions

Major alternatives discussed by the “Gates Committee”

1. Personal income tax – 1%; no exemptions	\$1,639
2. Personal income tax – 1%; \$5,000 per exemption	\$1,356
3. Personal income tax – graduated rates 3% - 5.5%	\$6,653
4. Corporate net income tax – 16%	\$2,300
5. Value added tax – 1.1%	\$2,100
6. Unified goods and services tax – 4%	\$7,700
7. Modified VAT/flat tax on wages – 4.2%	\$7,700

Other tax alternatives

8. Increase sales/use tax rate:	
a. 0.1% - 6.5% to 6.6%	\$96
b. 0.2% - 6.5% to 6.7%	\$191
c. 0.3% - 6.5% to 6.8%	\$287
d. 0.4% - 6.5% to 6.9%	\$382
e. 0.5% - 6.5% to 7.0%	\$477
f. 0.6% - 6.5% to 7.1%	\$572
g. 1.0% - 6.5% to 7.5%	\$949
9. Extend sales tax to consumer services	\$352
10. Extend sales tax to business services	\$1,026
11. Extend sales tax to financial services	\$785
12. Extend sales tax to medical services	\$564
13. Extend sales tax to manufacturing machinery	\$162
14. Extend sales tax to food	\$670
15. Extend sales tax to prescription drugs	\$250
16. Extend sales tax to barber/beautician services	\$22
17. Extend sales tax to cable television	\$36
18. Extend sales tax to motor vehicle fuel	\$183

	Annual Collections - 2005 <u>\$ in millions</u>
19. Increase B&O and public utility taxes	
a. 10% surtax on all rates	\$258
b. 20% surtax on all rates	\$517
c. 25% surtax on all rates	\$646
d. 40% surtax on all rates	\$1,033
20. Increase B&O service rate – 1.5% to 1.75%	\$138
21. Payroll tax - 3¢ per hour	\$150
22. Soft drinks – 1 cent/12 ounces	\$35
23. State property tax levy increased 22.5¢	\$135
24. Real estate excise – 1.28% to 1.6%	\$114
25. State tax on all gambling activities	\$76
26. Non-tribal electronic slot machines	\$120 - \$300
27. Lottery-run video machines	\$272

Sources for collection estimates:

Items 1-7 – Washington State Dept. of Revenue at the request of the Washington Tax Structure Committee, August 9, 2002.

Items 9-18, 20, 22-25 – Washington State Dept. of Revenue, October 21, 2002.

Items 8 and 19 – derived from “Washington State Tax Structure Study SimTax Model.”

Item 21 – HECB staff analysis, September 10, 2002.

Item 26 – Quote from Lincoln Ferris, *Seattle Times*, October 6, 2002.

Item 27 – Washington State Lottery.

RESOLUTION NO. 02-32

WHEREAS, The Washington Higher Education Coordinating Board (HECB) is a citizens board appointed by the Governor and confirmed by the Senate and is required to make budget recommendations for higher education funding to both the Governor and the Legislature; and

WHEREAS, Years of limited state funding support, across-the-board budget cuts, and assumptions of “efficiency increases” as a way to avoid funding enrollment growth have resulted in a drop of state per-student support of nine percent at public four-year institutions since the 1991-93 biennium, adjusted for inflation. The financial responsibility for college expenses is being continually shifted to students and their families, threatening the ability of those with limited means to participate; and

WHEREAS, The HECB has determined that establishing benchmarks for funding levels is an appropriate approach to establishing a total system-wide level of state investment in higher education, that Washington institutions receive substantially less state funding per student than comparable institutions located in other states, and the Board has recommended funding for public higher education be benchmarked to the average of these comparable institutions; and

WHEREAS, The public higher education institutions enrolled more than 12,000 FTE students in excess of the level funded by the state in fiscal year 2002, and by 2010 an additional 29,000 FTE students above this state-supported level are expected to seek higher education; and

WHEREAS, The HECB has found that the state should meet its responsibility to enable those students with limited means to participate in higher education through carefully designed and adequately funded financial aid programs; and

WHEREAS, The HECB has determined that reaching these goals for the operating budget in the 2003-05 biennium would be accomplished by adding 15,571 new student FTE enrollments, increasing per-student state funding at the average level of comparable institutions, and achieving the current HECB financial aid goals. The total cost for these investments is \$1.1 billion in the 2003-05 biennium, in addition to the \$2.7 billion currently being spent on higher education; and

WHEREAS, The HECB requested public institutions clearly explain to the Governor, Legislature and the HECB how these additional resources will be used, and the benefits that will accrue; and

WHEREAS, The HECB recommended that in the 2003-05 biennium the Governor and Legislature provide additional state investments in the higher education operating budget to begin to accomplish the goals outlined by the HECB. The approximately \$1.1 billion estimated to meet this need in the 2003-05 biennium could be invested over four years;

THEREFORE, BE IT RESOLVED, That the HECB recommends that state revenues be increased in the magnitude of \$500 million per year to accomplish the recommendation that funding for higher education be increased; and

THEREFORE, BE IT FURTHER RESOLVED, That the HECB recommends that these additional funds for higher education be dedicated to higher education and be in addition to what is currently being spent on higher education (the maintenance level budget as calculated by the Office of Financial Management), and that the higher education institutions that receive these funds be held accountable for how the funds are spent; and

THEREFORE, BE IT FURTHER RESOLVED, That the HECB finds that the amount of new revenue being discussed is roughly equivalent to what would be raised by increasing the retail sales tax rate by one-half cent (with the state sales tax rate being increased from 6.5 percent to 7.0 percent), however, the HECB recognizes that there are many other possible sources of new funding and does not recommend any particular revenue option and is committed to working with the Governor and Legislature to identify potential sources.

Adopted:

December 12, 2002

Attest:

Bob Craves, Chair

Pat Stanford, Secretary